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## **New Zealand**

## **Dairy and Products**

## **Annual**

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**Report Highlights:** New Zealand's dairy industry is being challenged this season to optimize its product-mix to maximize industry returns in a low-priced international dairy marketing environment. Total production of powdered milk, butter, and cheese this season is forecast to increase 160,000 tons over last year. Export volumes for powdered milk and butter will be up this year, while cheese shipments will decline in response to heavy global supplies and weak prices.

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Includes PSD changes: Yes

Includes Trade Matrix: Yes

Annual Report

Wellington [NZ1], NZ

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## **SECTION I. EXECUTIVE SUMMARY**

The current season will be a particularly challenging one for New Zealand's dairy industry. Fonterra, a grower cooperative which accounts for nearly 97 percent of New Zealand's milk production, is now entering its second year of operation. Fonterra finds itself under intense media scrutiny and industry criticism for its operating losses. Although media articles have focused on issues such as Fonterra's executive salary structure, its operating losses are more fundamentally tied to the pricing decisions made last year by Fonterra for milk paid to its farmers. Last year's good returns to farmers has set in motion the likelihood that milk production will increase to 14.2 million tons in the current 2002/03 season. New Zealand's combined output of powdered milk, butter, and cheese this year will exceed last year's level by 160,000 tons. Faced with increased production levels and only modest domestic consumption requirements, Fonterra must make crucial milk pricing and export marketing decisions to enhance its operating margins.

Fonterra will attempt to manage its dairy export sales program this year to achieve a maximum shipping volume which minimizes the buildup of stocks in New Zealand, while at the same time avoiding oversupply situations which lead to price instability. This balancing act occurs at a time of low international dairy product prices and uncertainty over the pace of global price recovery. Although Fonterra has publicly stated that it seeks to reduce its dairy stocks, end-of-season inventories for powdered milk and butter in 2002/03 will be higher than a year earlier. Avoiding an inventory buildup risks moving quantities into export markets which might threaten sales price stability. Post forecasts New Zealand's total export volume for all dairy products will increase 60,000 tons in 2002/03.

Following the deregulation of the dairy industry last year and the creation of Fonterra, New Zealand's capacity to make product mix adjustments in response to changing market conditions has been enhanced. Prior to deregulation, the Dairy Board was the statutory body which handled all export sales. The two dominant cooperatives in New Zealand, operating independently of each other prior to the creation of Fonterra, often arrived at their production decisions based upon achieving company goals rather than industry objectives. Fonterra represents the merger of these two cooperatives and now accounts for more than 95 percent of all dairy exports. Current weakness in international cheese price levels, reflecting high global stocks, is encouraging Fonterra to direct additional milk processing volumes toward powdered milk and butter this season. In the medium-term, the industry is likely to redirect its growth toward cheese rather than butter as consumer demand for cheese strengthens, stock levels are reduced, and cheese prices improve.

Fonterra estimates its final (seasonal) milk payout to farmers for the 2002/03 season at NZ\$ 3.70 (U.S.\$1.74) per kilogram of milk solids compared to NZ\$ 5.30 in 2001/02. Some industry analysts, however, believe that Fonterra may be compelled to adjust its final payout for this season to as low as NZ\$ 3.30. This would allow it to better manage local milk supplies while responding to a greater appreciation of the New Zealand dollar and a slower recovery in dairy prices than initially anticipated.

Fonterra is continuing its strategy of international expansion through alliances and acquisitions to increase the scope of its international production and marketing activities. Its recent consolidation in the Australian dairy market and its deepening of its alliance with Nestlé – Dairy Partners Americas – is

reportedly progressing well. Fonterra hopes to achieve 10 percent annual growth through its international operations.

## SECTION II. STATISTICAL TABLES

PSD Table: Fluid Milk

PSD Table						
Country	New Zealand					
Commodity	Dairy, Milk, Fluid				(1000 HEAD)(1000 MT)	
	Revised	2001	Preliminary	2002	Forecast	2003
	Old	New	Old	New	Old	New
Market Year Begin		06/2000		06/2001		06/2002
Cows In Milk	3557	3557	3755	3749	0	3844
Cows Milk Production	13162	13162	13776	13925	0	14204
Other Milk Production	0	0	0	0	0	0
TOTAL Production	13162	13162	13776	13925	0	14204
Intra EC Imports	0	0	0	0	0	0
Other Imports	0	0	0	0	0	0
TOTAL Imports	0	0	0	0	0	0
TOTAL SUPPLY	13162	13162	13776	13925	0	14204
Intra EC Exports	0	0	0	0	0	0
Other Exports	15	42	15	48	0	48
TOTAL Exports	15	42	15	48	0	48
Fluid Use Dom. Consum.	346	355	346	355	0	355
Factory Use Consum.	12759	12723	13373	13480	0	13759
Feed Use Dom. Consum.	42	42	42	42	0	42
TOTAL Dom. Consumption	13147	13120	13761	13877	0	14156
TOTAL DISTRIBUTION	13162	13162	13776	13925	0	14204
Calendar Yr. Imp. from U.S.	0	0	0	0	0	0
Calendar Yr. Exp. to U.S.	0	12	0	0	0	0

PSD Table: Cheese

PSD Table						
Country	New Zealand					
Commodity	Dairy, Cheese				(1000 MT)	
	Revised	2001	Preliminary	2002	Forecast	2003
	Old	New	Old	New	Old	New
Market Year Begin		06/2000		06/2001		06/2002
Beginning Stocks	34	34	25	27	25	43
Production	281	281	330	312	0	270
Intra EC Imports	0	0	0	0	0	0
Other Imports	0	2	0	0	0	0
TOTAL Imports	0	2	0	0	0	0
TOTAL SUPPLY	315	317	355	339	25	313
Intra EC Exports	0	0	0	0	0	0
Other Exports	267	267	305	268	0	260
TOTAL Exports	267	267	305	268	0	260
Human Dom. Consumption	23	23	25	28	0	28
Other Use, Losses	0	0	0	0	0	0
Total Dom. Consumption	23	23	25	28	0	28
TOTAL Use	290	290	330	296	0	288
Ending Stocks	25	27	25	43	0	25
TOTAL DISTRIBUTION	315	317	355	339	0	313
Calendar Yr. Imp. from U.S.	0	0	0	0	0	0
Calendar Yr. Exp. to U.S.	38	32	38	38	0	50

PSD Table: Butter

PSD Table						
Country	New Zealand					
Commodity	Dairy, Butter				(1000 MT)	
	Revised	2001	Preliminary	2002	Forecast	2003
	Old	New	Old	New	Old	New
Market Year Begin		06/2000		06/2001		06/2002
Beginning Stocks	72	72	50	50	50	15
Production	352	352	340	321	0	400
Intra EC Imports	0	0	0	0	0	0
Other Imports	0	0	0	0	0	0
TOTAL Imports	0	0	0	0	0	0
TOTAL SUPPLY	424	424	390	371	50	415
Intra EC Exports	0	0	0	0	0	0
Other Exports	347	347	315	331	0	355
TOTAL Exports	347	347	315	331	0	355
Domestic Consumption	27	27	25	25	0	25
TOTAL Use	374	374	340	356	0	380
Ending Stocks	50	50	50	15	0	35
TOTAL DISTRIBUTION	424	424	390	371	0	415
Calendar Yr. Imp. from U.S.	0	0	0	0	0	0
Calendar Yr. Exp. to U.S.	27	21	26	27	0	19

PSD Table: Dry Whole Milk Powder

PSD Table						
Country	New Zealand					
Commodity	Dairy, Dry Whole Milk Powder				(1000 MT)	
	Revised	2001	Preliminary	2002	Forecast	2003
	Old	New	Old	New	Old	New
Market Year Begin		06/2000		06/2001		06/2002
Beginning Stocks	52	52	20	20	49	38
Production	480	480	505	540	0	600
Intra EC Imports	0	0	0	0	0	0
Other Imports	0	0	0	0	0	0
TOTAL Imports	0	0	0	0	0	0
TOTAL SUPPLY	532	532	525	560	49	638
Intra EC Exports	0	0	0	0	0	0
Other Exports	511	511	475	521	0	545
TOTAL Exports	511	511	475	521	0	545
Human Dom. Consumption	1	1	1	1	0	1
Other Use, Losses	0	0	0	0	0	0
Total Dom. Consumption	1	1	1	1	0	1
TOTAL Use	512	512	476	522	0	546
Ending Stocks	20	20	49	38	0	92
TOTAL DISTRIBUTION	532	532	525	560	0	638
Calendar Yr. Imp. from U.S.	0	0	0	0	0	0
Calendar Yr. Exp. to U.S.	3	4	3	4	0	3



PSD Table: Non-Fat Dry Milk Powder

PSD Table						
Country	New Zealand					
Commodity	Dairy, Milk, Nonfat Dry				(1000 MT)	
	Revised	2001	Preliminary	2002	Forecast	2003
	Old	New	Old	New	Old	New
Market Year Begin		06/2000		06/2001		06/2002
Beginning Stocks	71	71	98	98	98	85
Production	227	227	225	237	0	300
Intra EC Imports	0	0	0	0	0	0
Other Imports	0	0	0	0	0	0
TOTAL Imports	0	0	0	0	0	0
TOTAL SUPPLY	298	298	323	335	98	385
Intra EC Exports	0	0	0	0	0	0
Other Exports	195	195	220	245	0	265
TOTAL Exports	195	195	220	245	0	265
Human Dom. Consumption	5	5	5	5	0	5
Other Use, Losses	0	0	0	0	0	0
Total Dom. Consumption	5	5	5	5	0	5
TOTAL Use	200	200	225	250	0	270
Ending Stocks	98	98	98	85	0	115
TOTAL DISTRIBUTION	298	298	323	335	0	385
Calendar Yr. Imp. from U.S.	0	0	0	0	0	0
Calendar Yr. Exp. to U.S.	1	1	1	1	0	2

## Trade Matrix: Cheese

NEW ZEALAND DAIRY EXPORTS			
CHEESE			
	Calendar Year	Calendar Year	Jan-Aug
Destination	2000 (MT)	2001 (MT)	2002 (MT)
Japan	49,955	54,599	30,003
Australia	31,484	40,170	25,444
United States	32,356	38,203	37,050
Belgium	16,367	19,057	10,092
United Kingdom	11,625	14,832	10,719
Korea, South	9,132	12,056	6,505
Mexico	10,466	11,292	8,476
Saudi Arabia	5,301	8,281	7,166
Netherlands	879	7,450	1,255
Egypt	5,727	6,508	3,779
Algeria	5,970	6,407	4,000
Jamaica	4,755	5,736	1,581
Taiwan	6,158	4,955	3,799
Hong Kong	3,732	4,314	2,695
Venezuela	2,884	4,091	2,588
Malaysia	2,346	2,893	1,981
Panama	1,195	2,869	2,217
Philippines	2,818	2,457	2,132
Russia	3,614	2,114	965
Trinidad & Tobago	1,003	1,842	1,312
Indonesia	1,650	1,635	1,258
Singapore	2,951	1,586	987
Tunisia	766	1,503	1,032
El Salvador	1,784	1,446	52
Barbados	1,617	1,439	926
Canada	1,106	1,385	543
Other	20,274	18,310	14,726
TOTAL	237,915	277,430	183,283
Source: Statistics New Zealand			

## Trade Matrix: Butter

NEW ZEALAND DAIRY EXPORTS			
BUTTER			
	Calendar Year	Calendar Year	Jan-Aug
Destination	2000 (MT)	2001 (MT)	2002 (MT)
United Kingdom	39,019	37,613	18,833
Belgium	41,605	34,701	37,231
United States	19,711	26,598	14,855
Egypt	24,417	24,095	17,839
Mexico	17,461	21,011	11,273
Canada	11,408	18,113	7,890
Latvia	15,374	15,565	21,484
Iran	30,238	15,225	15,459
Australia	9,822	10,065	4,103
Taiwan	10,597	8,971	6,476
Hong Kong	6,784	8,845	4,394
Morocco	7,016	5,938	5,344
Algeria	2,834	5,184	4,123
Saudi Arabia	6,593	5,170	4,171
Denmark	3,866	5,061	3,722
Singapore	16,023	4,914	5,332
Philippines	5,225	4,534	3,546
Malaysia	4,763	4,480	2,376
United Arab Emirates	11,330	4,453	2,323
Thailand	2,407	3,915	3,528
Indonesia	3,638	3,803	3,713
Russia	7,183	3,656	4,971
Vietnam	4,768	3,039	2,363
Other	46,408	28,386	30,837
TOTAL	348,491	303,335	236,184
Source: Statistics New Zealand			

## Trade Matrix: Dry Whole Milk Powder

NEW ZEALAND DAIRY EXPORTS			
DRY WHOLE MILK POWDER			
	Calendar Year	Calendar Year	Jan-Aug
Destination	2000 (MT)	2001 (MT)	2002 (MT)
Vietnam	20,908	57,869	7,250
Indonesia	44,624	51,464	30,385
Venezuela	29,954	44,895	7,663
Malaysia	61,092	44,265	32,356
Mexico	7,212	40,588	20,259
Philippines	24,835	35,382	25,789
Sri Lanka	27,705	31,857	20,394
Thailand	30,578	31,818	19,292
China	23,652	29,720	30,865
Taiwan	18,375	21,127	12,781
Saudi Arabia	17,375	21,007	16,070
El Salvador	16,234	17,512	9,016
Canada	10,502	11,812	13,073
Cuba	3,044	10,864	8,288
Hong Kong	15,709	10,576	2,748
Peru	12,373	9,672	3,958
Singapore	17,975	8,283	10,710
Algeria	7,618	7,589	8,219
Australia	8,213	7,561	5,276
United Arab Emirates	9,064	5,995	3,873
Kuwait	5,130	5,185	3,867
Colombia	75	4,870	443
Japan	2,427	4,832	4,766
Dominican Republic	2,672	4,207	2,526
Mauritius	3,302	3,844	2,257
United States	4,113	3,558	1,023
Bangladesh	2,925	3,235	4,281
Other	28,681	26,640	55,433
Total	456,368	556,231	362,860
Source: Statistics New Zealand			

## Trade Matrix: Non-Fat Dry Milk Powder

NEW ZEALAND DAIRY EXPORTS			
NON-FAT DRY MILK POWDER			
	Calendar Year	Calendar Year	Jan-Aug
Destination	2000 (MT)	2001 (MT)	2002 (MT)
Philippines	20,271	29,480	12,908
Malaysia	20,804	24,727	11,370
Taiwan	16,805	19,789	10,446
Indonesia	14,004	18,686	14,487
Japan	13,714	18,513	17,971
Thailand	5,851	15,277	13,871
Saudi Arabia	11,834	11,170	7,754
Cuba	0	10,167	4,375
Hong Kong	9,848	9,669	3,793
Vietnam	5,900	9,301	8,486
China	5,981	7,061	10,264
Egypt	3,333	4,760	1,087
Venezuela	3,333	4,432	1,841
Mexico	3,174	4,414	8,206
Peru	4,887	4,201	3,619
Australia	3,609	3,308	1,218
Myanmar	2,253	3,194	1,994
Singapore	4,075	3,084	4,900
Yemen, Rep of	1,995	2,857	1,730
Sri Lanka	3,022	2,150	3,527
Brazil	2,133	1,296	867
Trinidad & Tobago	512	1,182	660
Dominican Republic	1,299	1,168	842
Korea, South	880	1,130	1,333
Jamaica	296	1,118	1,354
Estonia	0	1,067	0
United Arab Emirates	757	1,065	373
United States	638	936	1,192
Canada	180	935	1,039

Other	4,706	9,149	22,986
Total	166,094	225,285	174,494
Source: Statistics New Zealand			

### SECTION III. PRODUCTION & TRADE

#### *Milk Production*

Revised New Zealand milk statistics reveal that total milk production during the 2001/02 season (June-May) increased nearly 6 percent to 13.9 million tons. Farmers maximized sales revenue by taking advantage of the attractive milk prices being paid by Fonterra and excellent autumn pastures by milking their cull dairy cows late into the season. Fonterra's milk production in May 2002 was 23 percent higher than May 2001. Daily milk production at the end of May was 65 percent higher than a year earlier. North Island and South Island milk production increased 4 percent and 13 percent, respectively, during the 2001/02 season.

Forecast growth in New Zealand's milk production in 2002/03 will fall short of last year. Dairy farm conversions as well as expansion of existing operations is slowing in response to anticipated lower farm returns and the higher costs facing farmers thinking of entering the industry. Early season reports indicate that production to date is lower than anticipated due to unseasonably dry and cold conditions in some parts of the North Island and in the south of the South Island. The industry projects that milk production from the South Island will increase 15 percent this year while North Island milk production will remain static. Dairy cattle numbers in the North Island continue their downward trend. Regional production statistics confirm this ongoing north-south move. South Island milk production accounted for 24 percent of New Zealand's milk output in the 2001/02 season compared with 19 percent 5 years ago. Over the same period, milk production on the South Island increased nearly 60 percent while North Island production increased only 15 percent.

#### *Herd Statistics*

New Zealand's dairy herd for the 2002/03 season (June-May) is estimated at 3.84 million animals. (Note: this figure reflects dairy cow numbers at the beginning of the season.) Growth in New Zealand's dairy herd is slowing. This reduced growth reflects the industry's expectation of: 1) Lower milk payouts compared to previous years due to the anticipated appreciation of the New Zealand dollar and weaker international dairy product prices. 2) Increased producer payments to Fonterra. New, as well as existing dairy farmers which increase production, face a payment to Fonterra of NZ\$ 3.85 (U.S.\$ 1.81) for every kilogram of milk solids (MS) they produce this season. Prior to deregulation of the industry in 2001, farmers paid only NZ\$ 2 per additional kilogram of MS. These payments are assessed against milk collections by Fonterra. Producers are allocated milk collection rights in relation to shares owned in the cooperative.

New Zealand's regional shift in dairy farming from the North Island to the South Island continues. All

new dairy farm conversions this season are taking place in the South Island. The trend is driven by dairy farmers selling productive farm land in the North Island and investing in dairy properties in the South Island which offer more attractive operating returns due to lower farm property values and good year-round pasture conditions. The conversion of existing dairy farms in the North Island to smaller, non-commercial 'lifestyle' farm blocks is also discouraging dairy activity by adding to land value and production costs. Ownership of these lifestyle units is sought by urban dwellers seeking to enjoy a rural living environment while maintaining their primary income source from jobs in the city.

### *Cheese*

Post forecasts cheese production in the 2002/03 season to fall 14 percent to 270,000 tons. Export volume, however, is projected to decline only modestly to 260,000 tons, resulting in a marked drawdown for this season's end-of-year cheese stocks. Current season export prices for New Zealand's cheese products are less attractive relative to market prices at which other dairy products are being sold. A delay in the recovery of cheese prices is anticipated due to high global cheese inventories. Monthly spot market prices for cheese are expected to bottom out in the near future as stocks are reduced.

The local industry feels that the outlook for cheese in the medium-term is more favorable, particularly in comparison to other dairy products. This results from a growing cheese utilization in convenience foods and by the catering and fast food sectors of developed countries.

### *Butter*

Post revised its previous estimate for butter production in 2001/02 downward to 321,000 tons. Fonterra reduced its butter and cheese production levels in favor of powdered milk last year based on relatively weak butter and cheese export prices. Butter exports fell only 5 percent to 331,000 tons in 2001/02, thanks in part to increased shipments to Latvia.

Butter export prices have shown greater strength in recent months than cheese. Fonterra is likely to respond to these price relationships by increasing its butter output in the 2002/03 season as much as 25 percent to 400,000 tons. In view of the current international dairy commodity situation, post expects that increases in New Zealand's butter production this year will be absorbed by both larger export shipments to 355,000 tons and an increase in end-of-season butter stocks.

The outlook for butter production and trade in the medium-term is not as encouraging. Finding export markets for butter is generally harder than for other products, and butter faces stiff competition from reduced fat spreads and margarine.

### *Whole Milk Powder*

Post has revised its estimate for whole milk powder production in 2001/02 upward to 540,000 tons. Although the industry had talked of a decline in exports last year, total shipping volume recorded a modest gain to 521,000 tons. Whole milk powder production in 2002/03 is forecast to increase to 600,000 tons. Despite a forecast increase in whole milk powder exports in 2002/03 to 545,000 tons, end-of-season stocks are likely to rise markedly to more than 90,000 tons.

Industry analysts expect that export price levels for whole milk powder will continue to recover at a moderate rate over the medium-term thanks to an expanded use for milk reconstitution. The increasing 'westernization' of Asian and non-OECD nations' diets combined with economic growth and rising incomes in these countries will support this trend.

#### *Non-Fat Dry Milk Powder*

Production of non-fat dry milk powder during the 2001/02 season increased nearly 5 percent to 237,000 tons. Exports rose 25 percent to 245,000 tons in response to increased demand from Thailand and Japan. Non-fat dry milk powder production is forecast to increase to 300,000 tons in the current 2002/03 season. Recent U.S. sales of non-fat dry milk under the Dairy Export Incentive Program (DEIP) appear to have had minimal impact on world prices. New Zealand's exports of non-fat dry milk powder are forecast to increase to 265,000 tons in 2002/03. Despite the increased export movement, end-of-season stock building will occur.

While international prices for non-fat dry milk powder have strengthened in recent months, price weakness is anticipated in the medium-term. This reflects the continued loss of share of the milk reconstitution market to whole milk powder, and high non-fat dry milk powder stocks in both the United States and the European Union.

#### *Farmgate Prices*

Fonterra forecasts a final payout for the 2002/03 season of NZ\$ 3.70 (U.S.\$ 1.74) per kilogram of milk solids (MS) compared to NZ\$ 5.30 in 2001/02. The fall in price to producers follows weaker international dairy commodity prices and the appreciation of the New Zealand dollar. Some industry analysts speculate that the 2002/03 final payout by Fonterra could even be lower. They point to the fact that Fonterra's forecast is based on an average exchange rate for the 2002/03 year of U.S.\$ 0.45 per 1 NZ\$. Many currency analysts now set this rate closer to U.S.\$ 0.50 per 1 NZ\$ which reduces export earnings in NZ dollar terms. Second, Fonterra is expecting a fairly quick recovery in international dairy product prices. This largely is based on the anticipation that the United States and the European Union will soon end their export subsidies. While spot market prices during August and September were stronger, the absence of any major sign of improvement in world economic conditions may produce a slower than hoped for price recovery. Many of New Zealand's dairy industry analysts expect that world economic growth rates will show significant improvement only towards the end of 2003. This would delay a dairy price recovery and would invalidate Fonterra's final payment projection for this season. Economic conditions outside Fonterra's control, coupled with the industry's forecast increased milk production, may compel Fonterra to adjust its final payout for 2002/03 to as



low as NZ\$ 3.30 to 3.40 per kilogram of MS. Fonterra already has modified its payout formula in response to changing market demands. The ongoing shift from fat-based to protein-based dairy products led Fonterra to reduce its price paid for fat content. In the 2001/02 season fat was valued at 42 percent of protein. For the 2002/03 season Fonterra will value fat at 36 percent of protein.

## **SECTION IV: INTERNATIONAL MARKETING STRATEGY**

### *Fonterra's International Expansion Strategy*

Fonterra plans to achieve 10 percent annual growth from its international operations. This will be achieved through its program of acquisitions and joint ventures (see GAIN NZ2013). Its alliance with Nestlé – Dairy Partners Americas – is moving ahead with production and marketing strategies in North and South America. Fonterra already is the largest exporter of U.S.-produced non-fat dry milk powder through its marketing arrangement with the U.S. cooperative Dairy America. Fonterra also is producing milk protein concentrates with its U.S. partner, Dairy Farmers of America. A recent acquisition in Mexico provided Fonterra with a lead into the Mexican cheese and spreads market. Fonterra brought its Anchor brand into a new marketing arrangement with the Lurpark brand of ARLA, Europe's leading cooperative. This will ensure that Fonterra obtains maximum marketing value from its Anchor brand in the European Union, with a focus on the U.K. In Australia, Fonterra is bringing together its existing production and marketing assets which will allow it to manage its business activities in that country more effectively. Fonterra has adopted the strategic view that its domestic market includes Australia, and that the consolidation of its 'home market' is crucial for its future success.

Fonterra's international marketing strategy highlights include:

### *Dairy Partners Americas Alliance*

Fonterra Co-operative Group Limited and Nestlé have taken another step forward in the implementation of their Dairy Partners Americas alliance which will operate in the Western Hemisphere of the region. The Alliance will initially focus on: (1) The establishment of chilled dairy products and liquid milk joint ventures in Argentina, Brazil and Venezuela. (2) The establishment of milk powder manufacturing joint ventures in Brazil and Argentina. (3) The sale of Fonterra's milk powder business in Venezuela and Central America to Nestlé. Dairy Partners Americas hopes to expand its operations to additional countries in the region. According to Fonterra, sales revenue will exceed NZ\$ 300 million (U.S.\$ 141 million) in its first year. Fonterra anticipates that additional steps to implement the alliance could be achieved without outside capital funding. Ultimately, Fonterra hopes that Dairy Partners Americas will achieve an annual sales turnover of more than NZ\$ 3 billion. This reportedly would make the alliance the market leader in every country in South and Central America it operates in.

### *Fonterra Expands in Australia*

Fonterra Co-operative Group Limited and the Melbourne-based Bonlac Foods Limited are merging their consumer food products operations in Australia and New Zealand. According to Fonterra, this will create a platform for further growth in Australia and throughout the Asian region. The merged company, Australasian Food Holdings Limited (AFHL), evolved from the combination of the New Zealand-owned businesses Mainland and Tip Top with the Australian-owned companies, Bonland Dairies and Peters & Brownes. Fonterra holds 75 percent of the shares in AFHL, Bonlac holds 11 percent, and Aorangi Laboratories and Calpa Pty Ltd each hold 7 percent. AFHL is projected to achieve annual sales of NZ\$ 2.3 billion (U.S.\$ 1.08 billion) and will employ 4,000 people. Brands such as Mainland, Tip Top Ice Cream, Meadow Fresh, Tararua, Galaxy, Ferndale, Huttons, Kiwi, Bega, Bodalla, Perfect Italiano, Western Star, Cadbury Ice Cream and Brownes will be marketed by AFHL in Australia, New Zealand and Oceania. The range of products covered under this portfolio of brands include milk, ice cream, cheese, butter, yoghurt, processed meats, and convenience foods.

According to Fonterra, AFHL is now the largest dairy consumer foods company in Australia and one of the largest in the Asian region. It therefore represents a very important company under Fonterra's consumer foods operation, New Zealand Milk. Apart from the strategic importance of the merger, operational synergies are expected to produce annual savings of NZ\$ 10 - 20 million (U.S.\$ 4.7 - 9.4 million). This will allow Fonterra to provide a NZ 10 cents (4.7 U.S. cents) increase in its final payout to dairy farmers in New Zealand.

#### *NZMP Wins Supply Contract with Mexico's Liconsa*

Liconsa, the Mexican state agency responsible for supplying milk powder and recombined milk to impoverished Mexican families, has committed to a 12-month supply arrangement with Fonterra's ingredients division, New Zealand Milk Products (NZMP) for 20,000 tons of the fortified whole milk powder product, Tenutre. After storage trials were conducted in New Zealand and Mexico between May and August 2002, Liconsa made NZMP its principal supplier of the product. Liconsa already has a long-standing relationship with New Zealand through the former New Zealand Dairy Board, and has NZMP on its preferred suppliers list. Liconsa operates 8,500 retail outlets across Mexico which distribute subsidized milk powder and other food products. The new supply contract follows the purchase of 18,000 tons of milk powder from NZMP in 2001.

#### *Fonterra Enters Organic Dairy Products Market*

Fonterra has entered the world of organics with the production of 40 tons of organic cheddar cheese in September 2002. NZMP also produced approximately 200 tons of organic non-fat dry milk and whole milk powder in September. Fonterra currently has 13 organically-certified milk suppliers (farmers) in the North Island and has identified another 53 who have indicated an interest in converting to an organic production system. Fonterra understands that export marketing opportunities for organic dairy products are relatively modest at present. It views the outlook for organics, however, as positive and notes that organic dairy ingredients command a significant price premium over conventional

products.

## SECTION V: INDUSTRY ISSUES

### *Fonterra Becomes Part of Global Dairy Producers*

Fonterra has become part of an alliance of non-subsidized dairy producers that promotes the liberalization of trade in the global dairy industry. The Global Dairy Alliance (GDA) unites farming and industry representatives from Argentina, Australia, Brazil, Chile, Uruguay, and New Zealand. The GDA aims to reinforce efforts by governments of the Cairns Group to break down protectionism and trade-distorting subsidies. The GDA's key message is that there can be no positive outcome to the WTO Doha Round on agriculture without significant progress on the dairy products trade. According to Fonterra, dairy export subsidies worldwide cost the New Zealand dairy industry more than NZ\$ 1 billion (U.S.\$ 470 million) in lost sales revenue every year.

### *New Zealand and United States Win WTO Case Against Canada*

A WTO panel ruled for the third time that Canada's schemes to avoid WTO controls on export subsidies are in fact export subsidies. The Canadian approach to allow milk for export to be sold to processors at an international price below Canada's domestic price is seen by the United States and New Zealand as a subsidy. This scheme was a replacement for an earlier dairy export scheme which a WTO panel in 1999 considered illegal in terms of Canada's obligations under WTO rules. This most recent WTO panel decision is subject to appeal to the WTO Appellate Body whose report is not expected to be released until the end of 2002. The WTO panel's decision represents the fifth time that Canada has been unable to demonstrate that its dairy export pricing regime complies with WTO subsidy disciplines. From a New Zealand perspective, this is a matter of principle since Canadian dairy exports do not represent a major economic threat to New Zealand's industry. Fonterra believes that it is important that other exporters, the European Union in particular, do not adopt similar schemes. The New Zealand Minister of Trade Negotiations recently estimated that Canada's subsidy scheme costs the New Zealand dairy industry NZ\$ 80 million (U.S.\$ 37.6 million) per year.

### *Fonterra Launches Discussion Document to Help Retain NZ's Clean Green Image*

Fonterra has made it a priority to maintain New Zealand's clean, green image by seeking feedback from shareholders and industry stakeholders to a discussion document "Dairy Industry Environmental & Animal Welfare Policies". By working through a consultative and assessment procedure with suppliers, Fonterra hopes to establish a system of on-farm operational procedures that satisfies the requirements of overseas markets and farmers by being realistic and user-friendly. Fonterra has been working with the Ministry of Agriculture and Fisheries, the Ministry for the Environment, Regional Councils and

commercial companies to develop a set of "best on-farm practices". According to Fonterra, these world-leading management practices will help support New Zealand's claim to be clean and green. Areas addressed in the discussion document include: farm dairy effluent disposal, human waste disposal, fertilizer and pesticide residues, fertilizer usage, water quality maintenance, stock crossings, stock access to wetlands, and animal welfare issues such as tail docking and bobby calf collection. Fonterra acknowledges that the majority of its dairy farmers already comply with the proposed standards but maintain that an official document is necessary to enable the industry to support its claim of being clean and green in highly critical overseas markets.

#### *Government Funding for Industry Research*

Dexcel, the dairy industry's research, development, extension and education organization, has secured more than NZ\$ 5 million (U.S.\$ 2.35 million) in government research and development funding. Dexcel is an industry-owned entity which is funded through farmer levies. The funding application was approved by the Government's Foundation for Research, Science and Technology (FRST) for two new projects and ongoing existing research which will be conducted over a two to three year period. The FRST grants will target research areas where government funding had been declining. The funds will be used by Dexcel to expand its budget for "public good" activities (i.e. research not linked to a particular company or industry group but beneficial to the general livestock community) to NZ\$ 3.5 million (U.S.\$ 1.64 million). Two new research programs were initiated in July 2002 for reducing methane emissions by cattle and innovative food harvesting and monitoring technologies aimed at enhancing food quality, safety and compositional characteristics in dairy products. The latter program builds on existing industry-funded robot milking research and aims at achieving fully automated milk harvesting. Additional funding will be directed to Dexcel's existing research programs focusing on mastitis and reproduction in dairy cattle and improving the traceability of safe products and the development of natural low-impact solutions for animal welfare and the environment. Other FRST-funded Dexcel programs include research in sustainable dairy farming practices and milk characteristics.

#### *Fonterra's Biomedical Research Joint Venture Obtains Funding Approval*

LactoPharma Limited, a joint venture between Fonterra, the University of Otago and the University of Auckland, has obtained funding approval from the Foundation for Research, Science and Technology (FRST) to identify biomedical components in milk that advance bone growth and can be used as treatment for inflammatory diseases as well as cancers. FRST will provide NZ\$ 2 million (U.S.\$ 940,000) for the first year of the research and an additional NZ\$ 2 million (U.S.\$ 940,000) annually for the following 6 years. With co-funding from Fonterra, the total research budget is estimated at NZ\$ 28 million (U.S.\$ 13.2 million). FRST's grant will be subject to an ongoing performance assessment. The project will involve researchers at the Fonterra Research Centre (formerly New Zealand Dairy Research Institute), the University of Auckland's School of Biomedical Science and Medicine, and the University of Otago's Biological Investigation Group in Wellington.

*Gene Linked to Fat and Protein Content in Milk*

A gene that increases fat and protein levels in cow's milk has been discovered by BoviQuest. This research firm is a joint venture company formed by two farmer co-operatives, Fonterra-owned ViaLactia Biosciences and the breeding services company, Livestock Improvement. According to media reports, the discovery will give New Zealand world leadership in selectively breeding high-performing dairy cows. The gene does not increase milk production, but has been shown to increase fat and protein levels and to reduce water content in milk. The gene is linked to genetic differences between different dairy cow breeds. Jersey cows and high performing Holstein-Friesian cows were commonly found to have the gene in their genetic makeup. The discovery could potentially increase milk output value as much as NZ\$ 36 (U.S.\$ 16.9) per cow per year. The technology does not involve genetic modification, cloning or transgenic manipulation.

For additional information on the New Zealand dairy industry, please visit the following websites:

[www.fonterra.com](http://www.fonterra.com) and [www.fencepost.com](http://www.fencepost.com)